In the Supreme Court
OF THE
United States

OCTOBER TERM, 1940

No.

KETTLEMAN HILLS ROYALTY SYNDICATE No. 1 (a trust),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.

OPINIONS OF THE BOARD OF TAX APPEALS AND THE COURT BELOW.

The unreported memorandum opinion of the United States Board of Tax Appeals, entered January 23, 1940, appears at page 32 of the record. The opinion of the Circuit Court of Appeals, filed December 19, 1940, with rehearing denied January 21, 1941, appears at page 138 of the record. It is reported in 116 F. (2d) 382.

JURISDICTION.

The jurisdictional statement set forth in the petition (p. 2), for the sake of brevity, is adopted and incorporated herein.

STATEMENT.

The essential facts are stated in the petition, page 4. Of such facts it is desired to emphasize the following:

1. Petitioner was given broad incidental powers to be used for the protection of the trust corpus, should the occasion arise (R. 65).

2. The beneficiaries have not participated in its management (R. 58);

3. Contracts entitling one Smith to oil royalties from Associated Oil Company were assigned to petitioner (R. 43). These contracts, which were negotiated and executed long prior to the formation of petitioner (R. 42) (as modified by changes thereto arising from petitioner's consent to the government's oil conservation program) (R. 47, 48, 49, 51, 105, 106, 111) constitute petitioner's entire trust corpus (R. 57);

4. These contracts are liquidating contractual assets, as they cover depleting natural resources (R. 82, 86, 91, 106, 111).

5. The relationship between petitioner and Associated at all times has been that of obligee—obligor, not that of principal agent (R. 82, 86, 91, 105, 106, 111);

6. Petitioner has never received any income other than cash (R. 55) and has never exercised any election to receive its royalties in kind (R. 57);

7. Petitioner has distributed to its beneficiaries all of its income (less administrative expenses and taxes) periodically as received (R. 56, 122).

ARGUMENT.

I.

THE DECISION OF THE CIRCUIT COURT OF APPEALS HOLDING THAT THE SUCCESSIVE DECISIONS OF PETITIONER TO TAKE ITS ROYALTY IN CASH AND NOT TO TAKE IT IN KIND IS THE DOING OF BUSINESS IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS AND IN SO HOLDING SAID COURT HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. SUCH HOLDING IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS.

The opinion of the court below is bottomed on the proposition that the making of successive yearly decisions by petitioner to accept royalty in cash rather than in kind "is doing the business" (R. 142). The court below reached this conclusion by stating in substance that, if petitioner had elected to take in kind it would have had to dispose of the material thus taken, which necessarily would have involved the business of selling, an activity contemplated and authorized by the trust indenture (R. 141). As petitioner rests its case on the facts as they are, rather

than what they might have been had petitioner conducted itself differently; and, as petitioner never has received any royalty in kind, or performed the attendant profit-seeking acts of storing, selling or otherwise dealing with such material, that hypothetical portion of the opinion may be disregarded (*McCoach v. Minehill R. R. Co.,* 228 U. S. 295 at 305, 33 S. Ct. 419, 57 L. Ed. 842) except to the extent that the court thereby pointed out the existence of power or authority which was not used. There remains then the meat of the holding to the effect that the mere receipt and disbursement of cash received by reason of ownership of property (time honored trust functions) *plus* the *unexercised* power to depart from such purely trust functions and go into business, is the doing of business.

It is respectfully submitted such holding is in direct conflict with the following decisions of the Circuit Courts of Appeal of other jurisdictions:

The question presented in *Gardiner v. United States,* 49 F. (2d) 992 (C. C. A. 1) was whether the existence of unused broad powers in a trust organized to acquire certain properties from probate trustees and other properties, and generally to deal with the same, made the concern an association within the meaning of section 700(a) of the Revenue Act of 1924, 43 Stat. 253, 325, which is similar in that respect to the sections of the 1934 and 1936 acts under consideration. The court answered the question in the negative, stating the crucial test was in what the trustees actually did and not in the mere existence of long unused broad powers (p. 996).

Gardiner v. United States, supra, was followed in *Dunbar v. Commissioner of Internal Revenue,* 65 F. (2d) 447 (C. C. A. 1), the same question being before the court for determination with respect to a trust owning and holding real estate, the Revenue Acts of 1924 and 1926, containing similar provisions, being involved.

Myers v. Commissioner of Internal Revenue, 89 F. (2d) 86 (C. C. A. 7) similarly involved the question of the taxation of a trust, owning a single improved piece of real estate, under the applicable sections of the Revenue Acts of 1926 and 1928. The trustees had broad powers, including the right to hold, manage and dispose of the property and to exercise the same rights as if they were the absolute owners (p. 88), but did little except collect the rents and keep the building in a tenantable condition. The Commissioner's contention that the tax as an association should be sustained, because of the broad powers given the trustees, was unavailing and the decision of the Board upholding the tax was reversed.

In *Cleveland Trust Co. v. Commissioner of Internal Revenue* (115 F. (2d) 481, C. C. A. 6) (Petition for Certiorari denied 85 L. ed. Advance Opinions 664), the similar question was involved of whether a trustee corporation, owning a leased office building, was liable to taxation as an association under Section 801(a) (2) of the Revenue Act of 1934, herein involved. The trust, organized for investment purpose, acquired an improved property leased for ninety-nine years, subject to the lease, in trust for the use and benefit of holders of beneficial interests, there being 535 such

units. The trustee had the exclusive right to manage and control the estate as though it were the sole legal and equitable owner, with the right to make agreements, modifying, amending or supplementing the lease at its discretion. It exercised such authority by releasing the lessee and negotiating a new lease. The court held that the right to possession and disposition of the property, to lease or relet it, in case of default by the lessee, did not have the effect of making it an association.

To the same effect is the holding in *United States v. James E. Davidson,* 115 F. (2d) 799 (C. C. A. 6) involving the taxability of a trust as an association under the applicable provisions of the Revenue Act of 1934, supra. The trust was created by the assignment to a trustee of corporate stocks, bonds, notes, and bank deposits, to be held by the trustee for the beneficiaries or shareholders. There were 40,000 of these shares represented by transferable certificates. It had wide powers permitting it to sell, endorse commercial paper, lend and borrow money, etc. Although the trust indenture recited it was for the primary purpose of converting its assets into money and distributing the same to its beneficiaries, by its terms it was to terminate on the death of the last survivor of the trustor's children, or previously by the trustee. It was organized in 1923, but distribution did not start until 1935. It lent large sums of money to corporations in which it had stock interests, exceeding in one instance in excess of $1,600,000 and in the aggregate to another corporation in excess of $432,000. The government urged that the broad pow-

ers and quasi-corporate form of the trust required it to be taxed as an association. The court held otherwise, sustaining the District Court's finding for the taxpayer. Capital stock taxes were also recovered by the taxpayer in the same action.

B. THE CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

It is respectfully submitted in so holding the Circuit Court of Appeals has decided a Federal question in a way probably in conflict with the following decisions of this Court:

Zonne v. Minneapolis Syndicate, 220 U. S. 187, 31 S. Ct. 361, 55 L. Ed. 428, holding that

> "a corporation, the sole purpose whereof is to hold title to a single parcel of real estate subject to a long lease and, for convenience of the stockholders, to receive and distribute the rentals arising from such lease and proceeds of disposition of the land, and which had disqualified itself from doing any other business, is not a corporation doing business within the meaning of the corporation tax provisions of the act of August 5, 1909, C. 6, 36 Stat. 11, 112, and is not subject to the tax" (p. 187).

In the early case of *McCoach v. Minehill R. R. Co.,* supra, decided in 1913, in construing the Corporation Tax Law of 1909, supra, the analagous argument was made by the Government, as here made by the court, to the effect that a railroad corporation which had leased its railroad to another company operating it exclusively, but which maintained its corporate existence and collected and distributed to its stockhold-

ers the rental from investments was "doing business" within the meaning of the Corporation Tax Act of 1909. The court, speaking through Mr. Justice Pitney, stated on this point at page 305:

> "It should be mentioned that there is nothing in the record to show that during the taxing years in question the company exercised its powers of eminent domain or put in force any other special corporate power in aid of the business of the lessee. We therefore do not pass upon the question whether, if it should do so, it would be taxable under the act in question. We cannot, however, agree with the contention made in behalf of the Government that because the Minehill Company retains its franchise of corporate existence, maintains its organization, and holds itself ready to exercise its franchise of eminent domain, or other reserve power, if and when required by the lease, and ready to resume possession of the property at the expiration of the lease, it is therefore to be treated as doing business, in respect of the railroad, within the meaning of the Corporation Tax Law."

Having in mind the express and implied powers of railway corporate charters and in fact the powers mentioned in the quoted portion of the opinion, it must be apparent that the Minehill Railway Company had power to do many acts of a business nature, either annually, monthly, or daily, had it elected so to do; and that it not only expressly as to some, but tacitly as to others, determined not to exercise such powers. And yet, if one agrees with the reasoning of the Circuit Court of Appeals in the case at bar, such conclusions were "business judgments" consti-

tuting doing business. This court thought otherwise. The case is the controlling authority on the point today. See *Sears v. Hassett,* 111 F. (2d) 961 at p. 964 (Capital Stock Tax) and *Cleveland Trust Co. v. Commissioner of Internal Revenue,* supra, at p. 483 (Income Tax).

Although used by the First Circuit to decide a capital stock question, the *McCoach* case, supra, was followed in *Sears v. Hassett,* supra, as being binding on it in determining the question "with respect to carrying on or doing business for any part of such year" (p. 964) the court stating at page 965:

> "The *McCoach* case has been distinguished on its facts in later years (citing cases). It has not, however, been disapproved and we must accept it as a binding authority. See *Kingkade Hotel Co. v. Jones,* D. C. 30 F. Sup. 508."

In the *Sears* case the court was dealing with a trust having broad powers which had been used in part affirmatively by the trustees in prior years in the profit-seeking activities of securing a long-term tenant for a building owned by the trust and selling off parcels of land owned by the trust, so as to give rise to income tax liability as an association, although such use was not the basis upon which the court placed such liability, as it is respectfully submitted it should have done. But there the court rightly considered itself bound by the *McCoach* case as a controlling authority on the second and narrower question in the case whether, in the same and additional tax years, the trust was "doing business" so as to give rise to capital stock tax liability. Although the scope

of inquiry is broader in the former than in the latter case, in view of the fact that profit-seeking activities both within and prior or subsequent to the tax years in question, form, and purpose are relevant as to income tax liability as an association, whereas, only the question of doing business within the tax years in question is relevant as to the capital stock tax; nevertheless where, as in the case at bar, the issue has been narrowed and the only inquiry is whether the entity has done, or is doing business, the test on that narrow point is the same, and authorities controlling the one situation control the other. It is apparent that if the proposition relied on by the Circuit Court of Appeals in the case at bar were valid, the "business judgments" exercised by the trustees in the *Sears* case in refraining, in the capital stock tax years in question, from exercising their broad powers, would have constituted "the doing of business" requiring the imposition of the capital stock tax. Also, if such proposition were valid the court in that case could have relied on such doing of business in holding the taxpayer to be an association rather than relying erroneously, it is respectfully submitted, on the presence of unused power, as the court did (Cf. pp. 963-964).

There remains to be considered on this point the leading case of *Morrissey, et al., Trustees, v. Commissioner,* 296 U. S. 344, 80 L. Ed. 263, 56 S. Ct. 289, not because of its facts, which are quite dissimilar from those in the case at bar, but because of the criteria for distinguishing between trusts and associations laid down by the Chief Justice, and because the Cir-

cuit Court of Appeals relied on that case alone in its opinion (R. 142, 143). The Circuit Court stated at page 142:

> "It is our opinion that in making these successive decisions whether it will require the delivery of the royalty product in kind or in cash, the taxpayer 'is doing the business' within the decision of *Morrissey v. Commissioner,* 296 U. S. 344, 360, though through the tax years in question it thought it better business to accept cash rather than the oil products."

No portion of the Chief Justices' opinion is cited as being the authority for the novel proposition that the decision of trustees, whether periodic or otherwise, to confine themselves to non-business functions (the mere receipt and disbursement of money) is the doing of business. It would seem that the decision to do a thing, the doing of which is not "doing business" cannot be doing business. Furthermore, the Circuit Court of Appeals' opinion lacks a desirable degree of candor in failing to set forth that petitioner has never taken its royalty in kind. In fact the intimation in the opinion is the other way by the under-statement that, *"through the tax years in question* it thought it better business to accept cash rather than oil products". (R. 142) (emphasis supplied)

And it is respectfully submitted nothing in the *Morrissey* opinion justifies such holding.

Indeed, the language in the *Morrissey* case would appear to point the other way, toward a connotation of profit seeking activity as being one of the con-

trolling criteria, rather than passivity, in view of the Chief Justice's statement at pages 356 and 357 in said opinion that

> "'Association' implies associates. It implies the entering into a joint enterprise, and as the applicable regulation imports, an enterprise for the transaction of business. * * * In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gains."

II.

THE DECISION OF THE CIRCUIT COURT OF APPEALS IN HOLDING THAT THE ACTS OF PETITIONER IN MODIFYING ITS ROYALTY CONTRACTS IN CONNECTION WITH THE OIL OPERATORS' AND GOVERNMENT'S OIL AND GAS CONSERVATION PROGRAM CONSTITUTED THE DOING OF BUSINESS BY PETITIONER GIVING RISE TO TAX LIABILITY AS AN ASSOCIATION, BECAUSE PETITIONER EXERCISED ITS BUSINESS JUDGMENT IN SO DOING, IS IN CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS AND IN SO HOLDING SAID COURT HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH APPLICABLE DECISIONS OF THIS COURT.

A. SUCH HOLDING IS IN DIRECT CONFLICT WITH THE DECISIONS OF THE CIRCUIT COURTS OF APPEALS OF OTHER JURISDICTIONS.

The opinion states petitioner exercised "its business judgment" in entering into these "new" contracts. But what of it? Even trustees of pure or traditional trusts are permitted to use their business judgment in the protection of the trust corpus. In

fact, the more and better business judgment a trustee uses in switching from a bad or failing security holding to a good and solvent one, or in performing other protective acts, the better trustee presumable he would be. That is one of a trustee's functions. The *motive* is the important thing. The trustees consented to, or entered into, the North Dome and Middle Dome arrangements, as the stipulated facts clearly indicate, under exceptional circumstances and with the absence of any profit-seeking motive. They had no real alternative. They were not seeking after profits, but seeking to preserve what had been entrusted to their care. To stress the fact that "new contracts" or different contracts, in a technical, or even an actual sense, were made, is to grasp at the form and lose the substance of the matter.

It is respectfully submitted such holding is in direct conflict with the following decisions of the Circuit Courts of Appeals of other jurisdictions:

In *Cleveland Trust Company v. Commissioner of Internal Revenue* (C. C. A. 6) supra, the facts of which have already been stated, the court, in commenting on the right of trustees to deal with the trust's property as being an incidental power to be used under exceptional circumstances, stated at p. 484:

> "Under ordinary trusts, trustees are often empowered to substitute investments or sell property and to lease and rent the corpus of the trust, but to hold such transactions as creating an association for profit would be in effect to subject such trusts to the taxable status of corporations."

See also to same effect Note 10 at page 18 of *Fidelity-Bankers Trust Co. et al. v. Helvering,* 113 F. (2d) 14 (D. C.) regarding transactions of a business nature in connection with the preservation of trusts.

And, in *United States v. Davidson* (C. C. A. 6), supra, the facts of which also have been stated, the court approved the findings of the District Court that there was no conclusive evidence that the trust was engaged in business for the purpose of a livelihood or profit (p. 801). In fact the court found that the trustee had not so engaged and that the trustee "has done no more than hold and attempt to preserve the trust property and receive the ordinary fruits arising from its ownership" (p. 801). And yet, surely the acts of the trustee in lending over $2,000,000 to the sugar and steamship companies to protect the trustee's prior loan and his stockholdings must have called for the use of the trustee's "business judgment".

In the case at bar the "business activities" referred to in the opinion (R. 142) were of a non-profit seeking nature in the same sense (but for more obvious reasons) the successive acts of the trustee, in lending large sums of money in *United States v. Davidson,* supra, were held to be nonbusiness activities and incidental to the main purpose of the trust. As the stipulated facts in the case at bar show, the modifications of the royalty contracts were made in cooperation with the Department of the Interior and after Associated *had already assigned* the underlying leases to the Kettleman North Dome Association, all in

conformity with supervening public welfare, as part and parcel of a federal conservation program. It is not apparent what alternative to consenting the trustees had. It cannot fairly be stated that such acts of the trustees were profit-seeking. Indeed, the court did not so state. We have then, the holding of the court that acts of business judgment (even though devoid of profit-seeking motive) constitute the doing of business. It is respectfully submitted such holding is in direct conflict with the cases from other circuits cited herein and lays down a thoroughly unsound and unworkable rule of law.

B. THE CIRCUIT COURT OF APPEALS HAS DECIDED A FEDERAL QUESTION IN A WAY PROBABLY IN CONFLICT WITH AN APPLICABLE DECISION OF THIS COURT, NAMELY MORRISSEY, ET AL., TRUSTEES v. COMMISSIONER (SUPRA).

The governing principles with respect to the taxation of trusts as associations were laid down in the *Morrissey* case, supra. Nowhere therein is it suggested that the non-profit seeking acts of trustees for the protection of the trust corpus would constitute the doing of business; on the contrary that trustees might use their incidental power, without tax penalty, in the conservation of the trust property (in conjunction with their business judgment it is hoped) was recognized (but without taking the occasion to emphasize the point) in the following language therein:

> "In what are called 'business trusts' the object is not to hold and conserve particular property, with incidental powers, as in the traditional type of trusts, but to provide a medium for the conduct of a business and sharing its gain" (p. 357).

CONCLUSION.

The Circuit Court of Appeals has rendered a decision which not only is in conflict with numerous decisions of other Circuit Courts of Appeals and of this Court, but also in so doing it has enunciated unsound and unworkable criteria for distinguishing between trusts and associations and what constitutes doing business, certain to introduce additional confusion into an already confused distinction of real importance in the administration of the revenue laws.

It is respectfully submitted the Petition for Certiorari should be granted.

Dated, San Francisco, California,
April 14, 1941.

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